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Practice Notes:

Indonesian Economy Leading to a Political Year and How Foreign Banks Can Play a Role in Development*

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Abstract

Recently, Indonesia's economy records very high and stable economic growth. The growth is above 6 percent. Despite the world economic crisis, our economic growth is adequately resistant to turmoil from external crisis. The relatively high economic growth is mainly caused by high domestic demand, both from consumption and investment. The question is how foreign banks can play a role in development of Indonesian economy? In this notes, I discuss several challenges posed by structural changes in Indonesia as well as opportunities for foreign banks to play a role in Indonesian financial development.

Keywords: Economic Growth, Banking, Investment, Financial, Development

Introduction

Recently, Indonesia's economy records very high and stable economic growth. The growth is above 6 percent. In 2012, global economy was engulfed in a crisis that even caused both China and India as two leaders of world's economic growth to fall deeply with economic growth of 7.5 percent and 5.3 percent respectively. In the same year, Indonesia still could maintain growth above 6.23 percent, ranking second highest in the world after China. This shows that in macroeconomic aggregate, our economic growth is adequately resistant to turmoil from external crisis. The relatively high economic growth is mainly caused by high domestic demand, both from consumption and investment.

McKinsey recently published a report on Indonesia titled "The Archipelago Economy: Unleashing Indonesia's Potential." In the report, McKinsey predicted that in 2030 Indonesia will be the seventh largest economy after China, the United States, India, Japan, Brazil and Russia, taking over the position of Germany and the United Kingdom. McKinsey estimated that the rise of Indonesia from today's top sixteen to seventh rank in 2030 will be marked by the following variables:

1. There will be 135 million people as consumer group. Today, the number is 45 million people.
2. 71 percent of urban dwellers will produce 86 percent of GDP. Today, 53 percent of urban populations produce 75 percent of GDP.
3. There will be need for 113 million of skilled labors. Today, there are 55 million of skilled labors.
4. There will be \$1.8 trillion of market opportunities in consumers' services,

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farming and fisheries, resources and education. Today, there is \$0.5 trillion.

In 2013 Indonesia's economy is still projected to grow above 6 percent. The government estimates that our economy will grow 6.5 to 6.8 percent. Bank Indonesia projected the number a little below the estimates, which is 6.3 to 6.6 percent. The main cause is the continuing debt crisis in the European Union that hasn't showed significant improvement, delaying the rebound of global economy. Our main trade partners, such as Japan and the United States, haven't received increase in demands. Despite China showing revival, its growth is also still not too significant, approximately 8 percent.

The good performance of Indonesia's economy doesn't mean there is no problem within our economy. In our macro-economy, there are several pressures to our economic growth that requires attention.

1. First, the pressure on external balance.
2. Second, the pressure on budget deficit.
3. Third, the pressure on inflation.
4. Fourth, the pressure on rupiah's exchange rate.

The first pressure on our economy that requires attention is the problem of external balance, which is the current account balance. In 2012, for the first time since 1961 we experienced a deficit in our current account, totaling US\$24.2 billion, or 2.7 percent of our GDP. The number nearly touched the maximum deficit limit of 3 percent of GDP. This happened despite our current account still recorded a surplus of 0.2 percent of GDP in 2011. In the middle of 2012 most of the decrease came from the shrinking of non-oil and gas trade surplus. This was followed by the widening of oil deficit in recent months, peaking up to US\$23 billion in 2012. The overall of outbalance of payments still recorded

surplus thanks to inward foreign investments, in the forms of foreign direct investments (FDI) and foreign portfolio investments (FPI). We still need to maintain awareness on the high foreign investments, primarily on the potential of sudden capital reversal.

In 2013, the condition of pressure on external balance still doesn't show improvement. We can see this in January 2013, when our trade balance was still deficit of US\$171 million. This deficit happened because our exports in January 2013 were only US\$15.38 billion, while our imports were US\$15.55 billion. The deficit of trade balance in January 2013 was mainly caused by the high deficit in the oil and gas sector: up to US\$1.43 billion, with the deficit contribution from crude oil up to US\$554.7 million and from oil fuel up to US\$2.18 billion, while gas sector recorded surplus up to US\$1.31 billion. Exports of non-oil and gas in January 2013 recorded a surplus of US\$1.25 billion. Unfortunately, this surplus could not balance the high deficit from oil and gas sector.

The second pressure on our economy is from the state budget. The realization of 2012 state budget deficit was Rp146 trillion, or 1.8 percent of GDP. This deficit was lower than the target of 2012 state budget revision, which was 2.2 percent of GDP and reflects capital and goods expenditures that are lower than the estimates. Capital expenditures in the last five years showed decreasing average trend. The spending that surpassed target was energy subsidy expenditures, which are higher than stipulated, up to 3.7 percent of GDP, or increasing by 3.4 percent, in 2011. The spending was nearly one third of total central government expenditures. In 2013, the government will continue to be careful on the fiscal by stipulating budget deficit of 1.7 percent of GDP. This deficit target is estimated to increase significantly if the international oil price increases, causing the

subsidy allocation for oil fuel energy to also increase significantly. There are still challenges in the efforts to increase subsidy spending allocations and efficiency, although energy subsidy will keep weakening the adjustment of electricity tariff. Oil fuel subsidy specifically has contributed to the pressure, not only in the budget but also in the recent trade balance. Both two pressures cause Indonesia to experience twin deficits, which are budget deficit and current account balance deficit. Both deficits shall be kept not to exceed their maximum limits.

The third pressure on our economy is the inflation problem. In 2013 our inflation experience serious pressure. In 2011 and 2012 our inflation was maintained low, while the contrary happens in 2013. The inflation for the period of January to March 2013 has reached 2.43 percent, far exceeding the inflation in the same period in 2012 and 2011, which are 0.88 percent and 0.7 percent respectively. The high inflation number is caused by the inflation turbulence of volatile food prices. Meanwhile, the main inflation still can be maintained well. With high inflation trend in the first three months of 2013, it is difficult to achieve the 4.5 percent inflation as targeted by the government. It will be even more difficult if the government increase the fuel prices, which will press the administered prices inflation, causing the headline inflation to increase significantly.

The fourth pressure on our economy is the movement of rupiah that is consistently weakening since the beginning until the end of 2012. Rupiah's position on December 30th, 2011, was on Rp. 9,069 per US\$. In the afternoon transaction on Friday, December 28th, Rupiah's position was on Rp. 9,679 per US\$. The weakening of Rupiah during 2012 had reached 6.7 percent. According to Bloomberg data, Rupiah's weakest position was on December 26th, 2012, which was on Rp. 9,799 per US\$. Compared to other Asian currencies, Rupiah was one of the worst

performing regional currency in 2012. As comparison, South Korean Won managed to strengthen by 7.65 percent in 2012, Philippines Peso strengthened by 6.9 percent, Singaporean Dollar strengthened by 6 percent, Taiwanese Dollar strengthened by 4.2 percent, Thai Baht strengthened by 3.07 percent, and Malaysian Ringgit strengthened by 3.48 percent in the same period. In 2013 Bank Indonesia actively intervenes Rupiah not to exceed the psychological limit of Rp. 10,000 per US\$. This will eventually impact our foreign exchange reserves.

Aside from the four macroeconomic variables, there is another pressure that we need to examine, which is political pressure. It is important to mutually understand that we are currently in a special year. Some have called the years 2013 and 2014 as the political year. Turmoil in politics is often associated with political instability. Political instability is often associated with economic instability. Will the political year give positive impact to Indonesia's economy, or on the contrary, negative impact to our economy? This is the question that we will collectively answer. To answer the question, I will use two approaches. First, pragmatic approach. Second, institutional approach.

My first approach is the pragmatic approach. Political year will see increase in political activities. Political activities will increase spending on political activities. From the spending or consumption side, this will benefit us very well. Sectors related to political activities, such as telecommunication, media, transportation, printing industries et cetera, will experience significant increase. Bank Indonesia estimated that the total consumption related to political activities will reach Rp44.1 trillion, while the government estimated it will reach Rp. 58 trillion.

My second approach is the institutional approach. Political year will see increasing competition among political parties. Study results of several survey institutions show

that there is still no strong trend of who will be the strongest winner, both for legislative election and for executive or presidential election. The Commission for Election (KPU) has granted twelve political parties as election contenders. This condition causes the political map leading to 2014 to be very dynamic and difficult to predict. There are many surprises to come for the people.

On the other hand, the institutional aspect of the political parties is increasingly questioned. The image and credibility of political parties are in a point of intersection, between rise and fall. The emergence of several independent candidates in some regional elections shows that there is a growing mistrust on political parties. Even in some regional elections, the number of political parties supporting a candidate doesn't determine the electability of the candidate. It was shown in the last Gubernatorial Election for DKI Jakarta.

Political instability is very possible to happen if political elites can't achieve democracy consolidation for the sake of the interest of wider society. If political elites do maneuvers and take each others' interest as hostages, the government will not be able to perform effectively and will leave bad precedents for the next government. Despite that, learning from our experience, Indonesia has conducted several elections for the legislatures and president. The results are here for us to see. The conditions were secure and the elections were conducted smoothly without social and political turmoil in grass-root society.

Aside from the four economic pressures and political pressures, it is highly probable that you as banking practitioners have questions about what you can do to participate in the development process so that you can be part of solution for the national economy.

Firstly, one thing that often becomes serious attention by the public related to the banking role is the optimization of the

banking intermediation function. This is reflected on the low financial inclusion. The condition is seen in the low number of small and medium enterprises (SMEs) that can access funding, which is only 30 percent. The number of account ownership is still below 50 percent from the total of Indonesia population. Only 0.2 percent of domestic investors who enter capital market, while 30 percent are Singaporean investors and 12.8 percent are Malaysian investors. Only 19.6 percent of Indonesian people above 15 years of age have bank account, compared to 98.2 percent of Singaporean, 72.7 percent of Thai and 66.2 percent of Malaysian. In Southeast Asia, Indonesia's percentage is only better than Cambodia.

In the context of financial inclusion, the banking sector is expected to be able to answer structural problems, such as poverty and income gap. The poverty rate in September 2012 was still on 11.6 percent, or approximately 28.6 million people. The Gini ratio for Indonesia in 2011 had reached 0.41, the highest number since 1999. In the period of 1999-2010, the Gini ratio was only around 0.32 to 0.37. This signaled uneven development aspects. I have hopes that the banking sector can take its role in the effort to grant wider opportunity of financial access, especially to the poor.

Secondly, the banking efficiency. Indonesia's banking sector is one of the most profitable banking sectors in Southeast Asia. Unfortunately, our banking sector is also one of the least efficient. This is seen from the Operating Expense to Operating Income (BOPO) ratio and Net Interest Margin (NIM) that are still highest in Southeast Asia, which are 74.26 percent and 5.48 percent respectively. Compare the numbers with the Philippines' 74 percent and 4.08 percent, Thailand's 54.3 percent and 2.48 percent, Singapore's 42 percent and 2 percent, and Malaysia's 40 percent and 2.27 percent. Even according to Bank Indonesia, there are several banks with Operating Expense to

Operating Income (BOPO) ratio above 100 percent. Still there are several banks, which in development, experience significant decrease in Operating Expense to Operating Income (BOPO) ratio, especially state-owned banks. In the Indonesia banking statistics published by Bank Indonesia in September 2012, the ratio of Operating Expense to Operating Income (BOPO) ratio of state-owned banks had decreased from the average of 113.9 percent in January 2012 to 71.27 percent in September 2012.

Thirdly, our banking penetration is still very low (financial deepening). Our loan-to-deposit-ratio (LDR) is very high, that is around 84 percent, while the loan-to-GDP-ratio is very low, that is only 34 percent. This signals the lack of capital and funding factors in our banking sector. We need adequate investments to push our loan-to-GDP-ratio in the penetration. Aside from that, our banking sector also needs to prioritize the loan credits to productive sectors and minimize consumptive sectors. This is to ensure that not only the amount of credits that increases, but also the quality of the credits.

Fourthly, banks in Indonesia need to optimize the management of the export revenue (DHE). Bank Indonesia recorded the number of export revenue (DHE) held in banks abroad up to US\$22.3 billion during the period of January to October 2012. The value of export revenue (DHE) coming from domestic banks during October 2012 reached 85 percent or up to US\$12 billion, while those coming from foreign banks reached 15 percent or up to US\$2 billion. The percentage of export revenue (DHE) that is still held in banks abroad was 24.5 percent in 2009, 22.9 percent in 2010, 19.6 percent in 2011, and still decreasing to 15 percent in 2012. In total, export revenue (DHE) produced in the period of January to October 2012 reached US\$129.4 billion, US\$107.1 billion of which has come through domestic

banks, while the remaining US\$22.3 billion is still in banks abroad.

Fifthly, the optimization of liquidity excess. Since the 1997/1998 crisis until now, the money market has been experiencing structural liquidity excess. Starting from the fund for handling the banking crisis, the liquidity excess had continued to increase. The source has been the funding for state budget deficit, foreign capital inflow sterilization and payment of interest on bank liquidity in Bank Indonesia. To maintain the monetary stability, the liquidity excess has to be absorbed through monetary operation by the Bank Indonesia. The outstanding monetary operation by Bank Indonesia reached Rp382 trillion in February 2013. However, the liquidity excess is still used in the money market and monetary sector only. This condition shall be used to flow the existing liquidity excess to the development of productive real sector that has direct implication on the welfare of the people.

Sixthly, the development of Sharia banking industry. In general, the Sharia banking industry in Indonesia shows highly accelerating development above 40 percent per year in 2008 to 2012, while the average of national banking growth was only 16 percent per year. Therefore, the Sharia banking industry can be categorized as the fastest growing industries group. However, there are problems facing Sharia banking industry, such as the fulfillment of human resources' quantity and quality. High expansion of Sharia banking is not followed by the provision of proper human resources. Until now, the Sharia banking industry needs 20,000 human resources. This is a challenge and also an opportunity.

And how about the role of foreign banks in Indonesia and the responses related to the regulations? In the 1997/1998 crisis, the banking industry in Indonesia collapsed. This encouraged the government of Indonesia to deregulate the banking sector. This came in two forms:

1. Bank Indonesia became independent.
2. The opportunity for foreign investors to have 99 percent of the ownership of banks in Indonesia was opened.

By the entrance of foreign investors, we expected national banking sector to strengthen since foreign investors were seen capable to increase the capital aspect of national banking, to conduct good corporate governance and risk management, and also to increase the quality of human resources in the banking sector. The expectation was fulfilled since the contribution of foreign banks positively satisfied the development of national banking in all respectful aspects.

However, Indonesia's economy has been growing well. This also encouraged the active role of national banks to be increasingly better and to grow fast. Liberalization of financial sector and economic integration caused national banks to start recognizing the importance to be active not only in domestic market but also in international market. This was the beginning of the emergence of the aspiration and will of the national bank to reassess the banking regulations in Indonesia. The goal was so that the regulations give justice and fair competition between national banks and foreign banks, so that the banking industry will be healthy and mutually strengthening. There are several strategic issues emerging from recent banking regulations that may become important issues for national and foreign banks operating in Indonesia.

1. Firstly, the issue of reciprocal principle.
2. Secondly, the issue of multiple licensing.
3. Thirdly, the limitation of foreign ownership.
4. Fourthly, the status of open company (PT) in branch offices of foreign banks.

5. Fifthly, the minimum regulations for the position of Director or Commissioner.

Firstly, the issue of reciprocal principle. The principle can be understood because there were uneven regulations between domestic regulations in Indonesia and foreign regulations. Business efforts of banks in Indonesia became very limited when they had to operate in several neighboring countries. This created barrier for national banks to move and develop their business. In this context, regulation diplomacy between regulators and industry needs to be conducted to create just and fair regulations between two countries. There needs to be efforts and steps of cooperation between the regulators and the banking industry, such as fair cross-border supervision that is equal between countries, so that the regulations are conducive for healthy competition climate in banking industry. Application of reciprocal principle is also in the framework of strengthening the banking structure, industry and governance for the future.

Secondly, the issue of multiple licensing is important, not to limit but to encourage healthy foundations for the banking industry, so that the financial system will become stabile and can support the national economy as a whole. The foundations are strong capital aspects, prudent business expansion, good governance aspects and protection on consumers to the developing financial products. The single licensing practiced in Indonesia is not good for the strengthening of the fundamental aspects of banking industry because it is too loose and doesn't abide to the prudent principle.

Thirdly, the issue of limitation of foreign ownership and the obligation to change the legal body status to open company (PT) for branch offices of foreign banks, in my opinion, are not in the spirit of limiting and pressuring foreign banks. This

limitation is in the context of prudential aspects of managing national banking. After all, when the stocks are mostly owned by foreign investors, there are bad potentials for Indonesian banking. If one day a financial crisis happens, the potential for capital outflow is increasingly bigger. Indeed, Bank Indonesia has issued regulations about Capital Equity Maintenance Asset (CEMA) that obliges minimum capital funding, but this regulation has to be supported by stronger legal rule equal to Law (UU). This is important to assure the business and investment in Indonesia is conducted smoothly without worries on the legal and formal aspects. It is of no doubt that the government, parliament and national banking industry still need the role of foreign banks. The magnitude of need for investment capitals in the banking sector cannot be fulfilled by the local investors. The limitation of stock ownership by the foreign investors cannot be applied. What can be regulated is to gradually decrease foreign ownership and to start opening the opportunities for local investors to balance the ongoing dominance of foreign investors' ownership on the national banking stocks.

Fourthly, the obligation of branch offices of foreign banks to convert the legal status into open company (PT). It needs to be understood that the importance of an open company status is for protection, both to the foreign banks and also to overall national banking industry, from the contagion effect of the financial crisis of the mother company. Aside from that, with the status of open company (PT), the principles of governance of the foreign banks will follow the Law that has been specified in the Law of Open Company (UU PT) and other related Law with more binding. The capital funding and prudential aspects in management will also be strengthened with the status change. I can understand the objection from foreign banks, considering the change into open company (PT) is impossible to execute directly. It

needs adjustments and periodization. After all, change of a branch to be a legal body as an open company (PT) will impact the operational funding of the foreign banks in the future. It needs proper regulations, time and execution.

Fifthly, the minimum requirement of a Director or Commissioner. I agree with the proposal from FBAI that the requirement doesn't need to include minimum ten years of experience. I tend to value competence, credibility and capacity more, or a merit-based system, as the references to the minimum requirement of a Director or a Commissioner.

I have hopes that we can encourage the development of banking sector in Indonesia and create healthier and more stabile financial system for the sake of better national economy.